**Undistributed Partnership Profits Allocated To a Non-vested Partnership Interest.***Crescent Holdings, LLC, 141 TC No. 15*

The regs under [Code Sec. 83](javascript:void(0)) are clear that a distribution of profits on a non-vested partnership interest is taxable as compensation under [Code Sec. 61](javascript:void(0)).   
However, the regs do not address the treatment of *undistributed* profits allocated to a non-vested interest.

**Background**

The taxpayer, an individual, was a senior employee for a company of Crescent Holdings LLC, a partnership. Two investors each owned 49 percent of Crescent Holdings LLC. The taxpayer agreed to work for Crescent Holdings, in exchange for a two percent interest in Crescent Holdings, provided he worked for the company three years.

In year 1, Crescent Holdings issued a Schedule K-1, Partner’s Share of Income, etc., to the taxpayer**, allocating him $423,000 as his share of partnership income.** The partnership made no distributions to the taxpayer. In Year 2, the partnership issued **a Schedule K-1 allocating $3.6 million to the taxpayer** as his share of partnership income. Again, no amounts were distributed.

For both years, the taxpayer believed that he was not a partner and was not taxable on the undistributed income. However, he reported the income to the IRS and paid taxes on it. His employer paid him $2.4 million to cover his tax liability for the undistributed profits.

After Crescent Holdings’ financial condition declined, the taxpayer resigned his employment before three years had elapsed. The creditors of Crescent Holdings intervened in the bankruptcy proceeding, seeking repayment of the $2.4 million.

**Parties’ views**

The taxpayer argued that under [Code Sec. 83](javascript:void(0)), his interest was an interest in partnership capital that never vested. Therefore, he was not the owner of the interest and should not be allocated any partnership profits. The IRS made the same argument. The intervenors argued that the interest was a profits interest and that the taxpayer was liable on his share of the profits under [Rev. Proc. 93-27](javascript:void(0)), which treats the service provider as the owner of the interest from the date of grant, even if the interest is nonvested.

**Court’s analysis**

The main issue was whether the taxpayer or the other partners of CH should recognize the undistributed partnership income allocated to the taxpayer’s interest. The Tax Court found that:

* The two percent interest was a capital interest, not a profits interest. Therefore, [Rev. Proc. 93-27](javascript:void(0)) did not apply and did not require that the taxpayer be treated as the owner of the interest.
* The capital interest was property under [Code Sec. 83](javascript:void(0)). Therefore, [Code Sec. 83](javascript:void(0)), not [Code Sec. 721](javascript:void(0)), applied to the non-vested interest transferred for services, and the taxpayer was not the owner of the interest.
* The undistributed income allocated to the taxpayer was not the taxpayer’s income, because the taxpayer did not own the interest. Instead, CH, the transferor, owned the interest. The income allocated to that interest was allocable to the partners holding the remaining interests in CH.

*References:*[*CCH Dec. 59,705*](javascript:void(0))*;*[*TRC COMPEN: 18,350*](javascript:void(0))*.*